
State Controller's Financial Overview

ECONOMIC OUTLOOK

California's economy continues to build strong momentum. A high number of Californians are working, fewer are unemployed, the real estate market is in full recovery, and increased personal income is generating higher revenues to the State. There is every reason to be positive as the State enters 1998.

Robust job growth in particular is propelling the Golden State's economy. During the past year, California's employment gains exceeded the national rate. More than 1.2 million jobs have been created in California since May 1993, the worst point of the recession. The outlook for 1998 is for employment to maintain a steady annual growth rate of 2.8%. Unemployment in the State is expected to drop below 6% by the end of the year.

Incomes in California are rising in response to the economy's growth. For calendar year 1997, it is expected that personal incomes will have risen by 6.7%. This in turn should keep state revenues growing. Personal income tax receipts, the largest source of revenue to the General Fund, increased by 11.2% during the year ended June 30, 1997. Overall tax receipts increased by 6.8% and are expected to remain strong.

One of the brightest spots in the California economy has been the recovery of the construction industry, the sector that has posted the largest gains in employment over the past year. In the 12 months ended October 1997, construction employment rose 9.6%. By the end of 1997, it is anticipated that more than 100,000 new residential units will have been built — the first time this has happened since 1991. Rising consumer confidence is reflected in the State's real estate market in general. Sales of existing single-family homes rose 13% in the third quarter of 1997 over the same quarter of 1996. The median price of a single-family home in California rose 6.9% in the same period.

Northern California's real estate market is especially strong. Double-digit price increases for single-family homes were widespread over the past year in many parts of the San Francisco Bay Area. In Santa Clara County — the heart of California's high-tech Silicon Valley — the median price of homes sold in the third quarter of 1997 rose 17.9% over the same quarter of 1996. Both residential and commercial real estate in the Bay Area are experiencing low vacancy rates, which is expected to further stimulate its real estate market in 1998.

In Southern California — the region of the State hit hardest by the 1990–93 recession — economic activity is picking up as well. Home prices in Orange County rose 7.9% in the third quarter of 1997; in Los Angeles County, home prices were up 2% over the same period

in 1996. Unemployment in Orange County was the lowest of Southern California's counties, estimated at just 3.3% in October 1997. Even in Los Angeles, ground zero of the recent recession, unemployment had dropped to 6.6%, far below the 8.1% recorded a year earlier.

The rebounding economy also has sparked renewed population growth in California. More plentiful jobs have resulted in fewer residents leaving the State and an increase in the number of people moving to California. The result is that, for the first time since 1993, California is again receiving more migrants than it is losing. This positive net migration will have a stimulating effect on the State's economy, particularly in the construction and service sectors.

As a leader in high technology and world trade, California is attracting talented workers from around the world. Of the adult migrants to the San Francisco Bay Area in 1996, 70% were college educated, according to the U.S. Census Bureau's March 1997 Current Population Survey. This pool of skilled workers will continue to invigorate the California economy for years to come. This also underscores the importance for California to invest in its education system. The State needs to provide students with the training necessary to be successful in this highly competitive, high-skill economy that is driving the state's economic future.

MAJOR INITIATIVES FOR THE YEAR

The 1997–98 Budget Act anticipates General Fund revenues and transfers of \$52.5 billion and expenditures of \$52.8 billion. This represents an increase of 6.8% in revenues and an 8.0% increase in expenditures. The 1997–98 Budget Act includes the following major features:

- The Budget Act contains a large increase in funding for K-14 education under Proposition 98. Funds are provided to fully pay for the cost-of-living-increase component of Proposition 98 and to extend the class size reduction and reading initiatives.
- The third year of a four-year “compact” that the Administration made with higher education units has been continued. Under this “compact”, funding from the General Fund for the University of California and California State University has increased by approximately 6%; there was no increase in student fees.
- Most other programs were continued at 1996–97 levels, adjusted for caseload changes, because of the effect of the pension payment.
- Health and welfare costs have been contained, generally continuing the grant levels from prior years, as part of the initial implementation of the new CalWORKs program.

- The Budget Act includes roughly \$300 million in federal funds, budgeted in federal fiscal years 1997 and 1998, to offset incarceration costs for illegal aliens.
- The Budget Act contains no tax increases or tax reductions. The Renter's Tax Credit has been suspended for another year, saving approximately \$500 million.

FINANCIAL INFORMATION

Reporting Entity: The financial reporting entity of the State includes all the funds and account groups of the primary government as well as all of its component units. Component units are legally separate entities for which the primary government is financially accountable. Blended component units, although legally separate entities, are, in substance, part of the primary government's operations and are included as part of the primary government. Accordingly, the building authorities are reported within the capital projects funds of the primary government. The lease agreements, amounting to \$312 million between the building authorities and the primary government, have been eliminated from the combined balance sheet. Instead, only the underlying fixed assets and the debt used to acquire them are reported in the appropriate account groups. Discretely presented component units are reported in separate columns in the combining financial statements to emphasize that they are legally separate from the primary government and to differentiate their financial position, results of operations, and cash flows from those of the primary government. The University of California and special purpose authorities are reported as discretely presented component units.

Budgetary Controls: Annually, the State Legislature prepares a budget that contains estimates of revenues and expenditures for the ensuing fiscal year. This budget is the result of negotiations between the Governor and State Legislature. Throughout the fiscal year, adjustments in the form of budget revisions, executive orders, and financial legislation agreed to by the parties are made to the budget. The Controller is statutorily responsible for maintaining control over revenues due the primary government and the expenditure of each appropriation contained in the budget. Budgeted appropriations are the expenditure authorizations that allow state agencies to purchase or create liabilities for goods and services.

The accounting system provides the Controller's Office with a centralized control record system to fully account for each budgeted appropriation, including its unexpended balance, and for all cash receipts and disbursements. The accounting system is decentralized in that the detail of each control account is maintained at the agency level. During the fiscal year, the control accounts and agency accounts are maintained and reconciled on a cash basis. At the end of the fiscal year, each agency prepares annual accrual reports for receivables and payables. The Controller's Office combines its control accounts with the agency accrual reports to prepare the *Budgetary/Legal Basis Annual Report* and *Budgetary/Legal Basis Annual Report Supplement*. The methods of

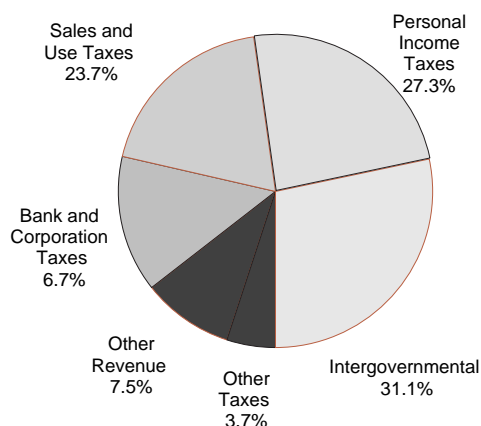
accounting for expenditures and revenues in this report are governed by State laws and regulations that, in some cases, are not in full agreement with generally accepted accounting principles. The information in the *Comprehensive Annual Financial Report* presents a consolidation of the amounts in the *Budgetary/Legal Basis Annual Report* and adjustments to the account balances to conform to generally accepted accounting principles.

Internal Controls: An internal control structure has been designed to ensure that the assets of the government are protected from loss, theft, or misuse, and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management. In addition, the government maintains extensive budgetary controls. The objective of these controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the Legislature.

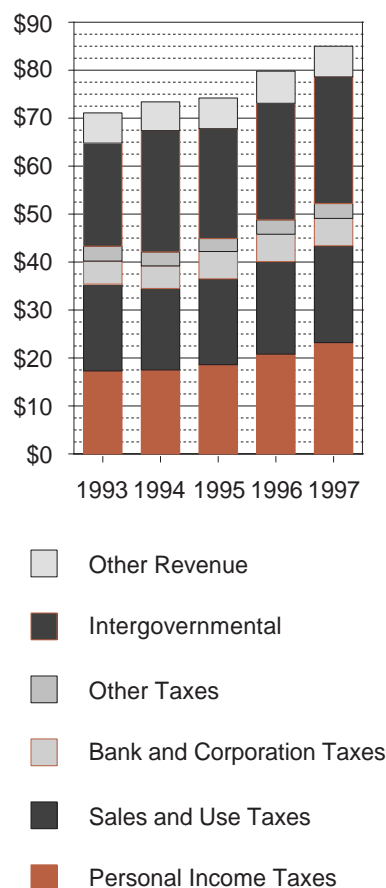
General Government Functions: The government provides a full range of services including education, health and social services, transportation, law, justice, public safety, recreation, resource development, and public improvements. These general government functions are accounted for in the General Fund, special revenue funds, and capital projects funds.

Chart 1

REVENUES 1996-97
General, Special Revenue, and
Capital Projects Funds

**Chart 2**

REVENUES by SOURCE
General, Special Revenue, and
Capital Projects Funds
 (Amounts in billions)



1996-97 Revenues: Table 1 presents a summary of General Fund, special revenue funds, and capital projects funds revenues for the year ended June 30, 1997. Revenues for the General Fund, special revenue funds, and capital projects funds totaled \$84.9 billion for the year ended June 30, 1997. This was an increase of \$5.0 billion, or 6.3%, over the previous year. Tax revenues increased \$3.3 billion, or 6.8%, over the previous year. Personal income, sales and use, and other taxes increased \$2.3 billion, \$911 million, and \$166 million or 11.2%, 4.7% and 5.6% respectively. Bank and corporation taxes decreased \$67 million or 1.2%. Intergovernmental revenue increased \$2.1 billion or 8.5%.

Five-Year Trend: Total revenues for the General Fund, special revenue funds, and capital projects funds have increased from \$71.1 billion in 1993 to \$84.9 billion in 1997 which is an increase of \$13.8 billion, or 19.4%. This trend of increasing revenue is the result of a rebounding California economy, which is generating increased collections of taxes. Personal income and sales and use taxes have increased from \$35.4 billion in 1993 to \$43.3 billion in 1997, which is an increase of \$7.9 billion, or 22.3%. Total revenues for the five-year period increased \$5.7 billion, \$2.4 billion, \$770 million, \$5.7 billion and \$5.0 billion in the years ending June 30, 1993, 1994, 1995, 1996, and 1997, respectively.

Table 1

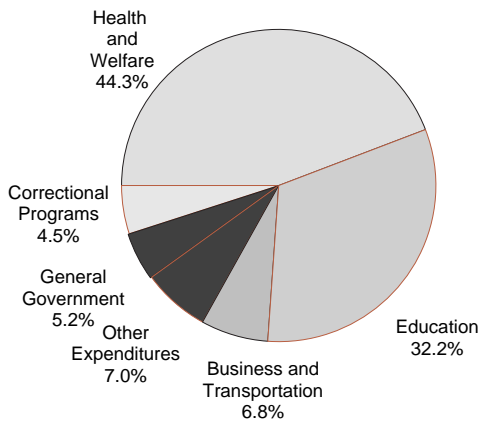
Schedule of General Fund, Special Revenue Funds, and Capital Projects Funds Revenues

Year Ended June 30, 1997 (Amounts in thousands)

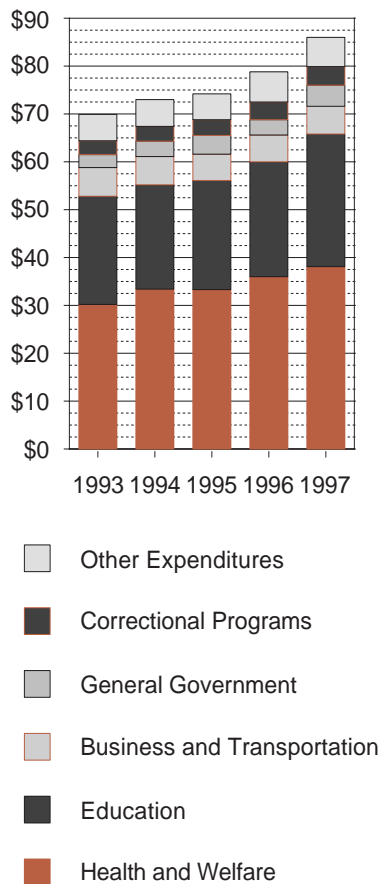
Sources	1996-97 Amount	Percent of Total	Increase (Decrease) from 1995-96	Percent of Increase (Decrease)
Taxes				
Personal income.....	\$ 23,176,711	27.3 %	\$ 2,331,271	11.2 %
Sales and use.....	20,166,671	23.7	910,781	4.7
Bank and corporation.....	5,674,049	6.7	(67,190)	(1.2)
Other taxes.....	3,129,880	3.7	166,285	5.6
Intergovernmental.....	26,397,371	31.1	2,059,609	8.5
Other revenue				
Licenses and permits.....	3,017,207	3.6	78,668	2.7
Fees.....	1,733,032	2.0	233,211	15.5
Other minor.....	346,501	0.4	(627,926)	(64.4)
Interest.....	504,934	0.6	9,047	1.8
Penalties.....	295,728	0.3	(106,717)	(26.5)
Charges for services.....	409,788	0.5	21,088	5.4
Natural resources.....	93,331	0.1	20,293	27.8
Total.....	\$ 84,945,203	100.0 %	\$ 5,028,420	6.3

Chart 3

EXPENDITURES 1996-97
General, Special Revenue, and
Capital Projects Funds

**Chart 4**

EXPENDITURES by FUNCTION
General, Special Revenue, and
Capital Projects Funds
 (Amounts in billions)



1996-97 Expenditures: Table 2 presents a summary of General Fund, special revenue funds, and capital projects funds expenditures for the year ended June 30, 1997. Expenditures for the General Fund, special revenue funds, and capital projects funds totaled \$86.0 billion for the year ended June 30, 1997. This was an increase of 9.1%, or \$7.2 billion, over 1996. Changes in expenditures by function from the previous year's levels are presented in Table 2. Major components of the change from the prior year are attributable to expenditures for education and general government. Education expenditures increased by \$3.7 billion, which was related to decreases in class size in Kindergarten through 3rd grade and increases in the average daily attendance. General government expenditures increased by \$1.3 billion, which was related to the accrued employer contribution to the Public Employees' Retirement Fund for the years ending June 30, 1996 and 1997.

Five-Year Trend: Total expenditures for the General Fund, special revenue funds, and capital projects funds have increased from \$69.9 billion in 1993 to \$86.0 billion in 1997, which is an increase of \$16.1 billion, or 23.0%. During this period, expenditures for health and welfare have increased 26.1%, education has increased 22.3% and corrections has increased 34.5%. In aggregate, expenditures for the five-year period increased (decreased) \$(423) million, \$3.0 billion, \$1.4 billion, \$4.6 billion, and \$7.2 billion in the

Table 2

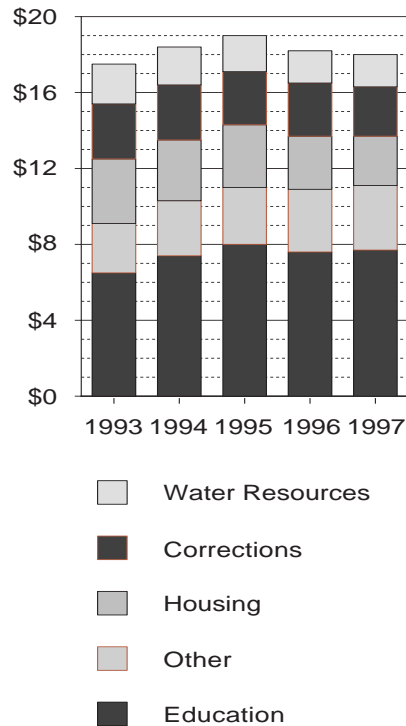
Schedule of General Fund, Special Revenue Funds, and Capital Projects Funds Expenditures

Year Ended June 30, 1997 (Amounts in thousands)

Function	1996-97 Amount	Percent of Total	Increase (Decrease) from 1995-96	Percent of Increase (Decrease)
Health and welfare.....	\$ 38,156,169	44.3 %	\$ 2,154,807	6.0 %
Education.....	27,661,080	32.2	3,682,587	15.4
Business and transportation.....	5,809,633	6.8	210,072	3.8
General government.....	4,439,586	5.2	1,252,627	39.3
Correctional programs.....	3,850,955	4.5	158,259	4.3
Other expenditures				
Debt service.....	2,151,042	2.5	(67,231)	(3.0)
Resources.....	1,911,656	2.2	88,287	4.8
State and consumer services.....	729,983	0.8	54,071	8.0
Property tax relief.....	630,957	0.7	160,830	34.2
Capital outlay.....	669,122	0.8	(491,239)	(42.3)
Total.....	\$ 86,010,183	100.0 %	\$ 7,203,070	9.1

Chart 5

**GENERAL
OBLIGATION BONDS
by FUNCTION**
(Amounts in billions)



years ending June 30, 1993, 1994, 1995, 1996, and 1997, respectively.

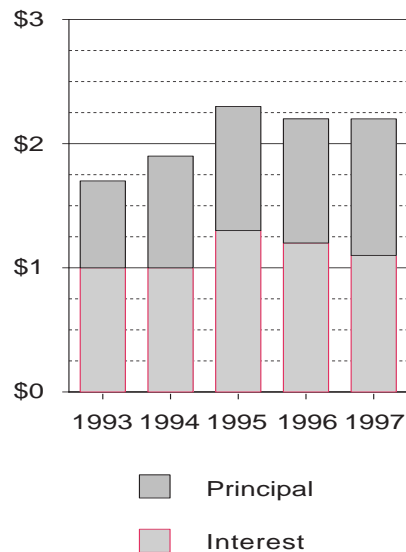
Debt Administration: On July 30, 1996, Standard and Poor's Rating Group raised its bond rating for California from "A" to "A+," and in February 1996, Fitch Investors Services raised its rating from "A" to "A+." Moody's Investors Service rating is "A1."

General Obligation Bonds: General obligation bond debt, which is backed by the full faith and credit of the General Fund, decreased from \$18.2 billion on June 30, 1996, to \$18.0 billion on June 30, 1997. This change reflected a decrease of \$252 million, or 1.4%.

Five-Year Trend: Total outstanding general obligation bonds have increased from \$17.7 billion in 1993 to \$18.0 billion in 1997. This is an increase of \$313 million, or 1.8%. During this period, education and other general purpose bond debt has grown from \$9.1 billion in 1993 to \$11.1 billion in 1997, which reflects an increase of \$2.0 billion, or 22.0%. Also during this period, bond debt for water resources, corrections, and housing have decreased from \$8.4 billion in 1993 to \$6.9 billion in 1997, which reflects a decrease of \$1.5 billion or 17.9%. In aggregate, general obligation bonds for the five-year period increased (decreased) \$1.7 billion, \$758 million, \$679 million, \$(871) million, and \$(252) million in the years ending June 30, 1993, 1994, 1995, 1996 and 1997, respectively.

Chart 6

**DEBT SERVICE
EXPENDITURES**
(Amounts in billions)

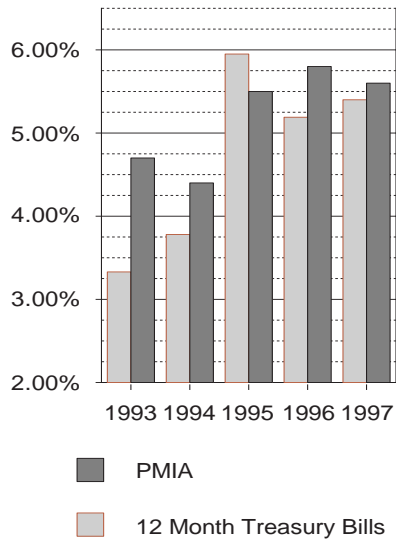


Debt Service: Principal retirement expenditures for the General Fund, special revenue funds, and capital projects funds totaled \$1.1 billion for the year ended June 30, 1997. This change reflected an increase of \$19 million, or 1.8%, over the previous year. Interest and fiscal charges for these funds totaled \$1.1 billion for the year ended June 30, 1997. This was a decrease of \$86 million, or 7.3%.

Five-Year Trend: General Fund, special revenue funds, and capital projects funds principal retirement expenditures increased from \$667 million in 1993 to approximately \$1.1 billion in 1997, which was an increase of \$392 million or 58.8%. Interest and fiscal charges increased from \$983 million in 1993 to approximately \$1.1 billion in 1997, which was an increase of \$109 million, or 11.1%.

Chart 7

**PMIA YIELD and AVERAGE
TREASURY YIELD
Year Ended June 30**



Cash Management Policies and Practices: Cash temporarily idle during the year was invested in the Pooled Money Investment Account (PMIA). The investment of the PMIA is restricted by law to the following categories: U.S. Government securities, securities of federally sponsored agencies, domestic corporate bonds, bank notes, interest-bearing time deposits in California banks and savings and loan associations, prime commercial paper, repurchase and reverse repurchase agreements, security loans, bankers' acceptances, negotiable certificates of deposit, and loans to various bond funds. The average daily investment balance for the year ended June 30, 1997, amounted to \$28.3 billion, with an average effective yield of 5.60%. For the year ended June 30, 1996, the average daily investment was \$26.6 billion and the average effective yield was 5.71%.

Five-Year Trend: PMIA yield increased from 4.70% in 1993 to 5.60% in 1997. During this same time, the 12 month average yield on Treasury Bills increased from 3.33% to 5.40%. The average daily investment portfolio has also increased from \$23.1 billion in 1993 to \$28.3 billion in 1997, which was an increase of \$5.2 billion or 22.5%.

The Pooled Money Investment Board's Annual Report for Fiscal Year 1996-97 disclosed that the total earnings of the PMIA in the year ended June 30, 1997, amounted to \$1.6 billion. Of this amount, \$251 million was distributed to the General Fund, \$734 million to special funds, \$593 million to local governments, \$2 million to the Public Employees' Retirement System, and \$2 million to the State Teachers' Retirement System. The Pooled Money Investment Account Portfolio is shown in Table 3.

Table 3

Pooled Money Investment Account Portfolio

Year Ended June 30, 1997 (Amounts in thousands)

Type of Security	Average Daily Portfolio	Percent of Portfolio	Annual Earnings	Average Effective Yield
Money market.....	\$ 15,612,908	55.1 %	\$ 869,925	5.6 %
Government securities.....	9,287,372	32.9	515,305	5.5
Corporate bonds.....	1,470,215	5.2	90,771	6.2
Loans to other funds.....	1,794,844	6.4	100,018	5.6
Repurchase agreements.....	84,896	0.3	4,591	5.4
Time deposits.....	419,648	1.5	22,376	5.3
Reverse repurchase agreements.....	(405,813)	(1.4)	(20,543)	5.1
Total Portfolio.....	\$ 28,264,070	100.0 %	\$ 1,582,443	5.6

General Fund Balance: The General Fund ended the year with a budgetary fund balance of \$640 million and a negative fund balance of \$2.5 billion using generally accepted accounting principles. The budgetary fund balance is made up of \$2.0 billion in reserves and a deficit of \$1.3 billion in the unreserved-undesignated portion of the fund balance. The reserves represent that portion of the fund balance that is not available for appropriation or that is legally set aside for specific uses. The unreserved-undesignated portion represents the amount available without restrictions to fund the subsequent year's budget. Because there was a deficit, no carry-over funds from the year ended June 30, 1997, are available to finance the budgetary plan for the year ending June 30, 1998. In addition, the General Fund needs to increase \$1.3 billion before funds become available for use as previously designated.

The Special Fund for Economic Uncertainties (the "rainy day fund") was fully depleted, leaving a zero balance at the end of the year. Annually, an amount is appropriated in the General Fund to replenish the fund. This fund, as the name implies, provides the monies for those necessary expenditures throughout the year that have not been anticipated or provided for in the annual budget. It also provides relief, to the amount of its available funds, for any budgeted revenue shortfalls.

Proprietary Operations: Proprietary fund types present financial data on activities that are similar to those found in the private sector. Users are charged for the goods or services provided.

Enterprise funds account for goods or services provided to the general public on a continuing basis when the cost involved is to be financed or recovered primarily by user charges. Enterprise funds earned approximately \$3.8 billion in operating revenues and had \$2.7 billion in operating expenses for the year ended June 30, 1997.

Internal service funds account for activities that provide goods and services to other State departments or agencies on a cost reimbursement basis. Internal service funds earned approximately \$1.3 billion in operating revenues and had \$1.3 billion in operating expenses for the year ended June 30, 1997.

Fiduciary Operations: Fiduciary fund types are used to account for assets held by the primary government as a trustee or agent. Three fiduciary fund types are reported: expendable trust funds, which account for assets held in a trustee capacity when both principal and income (earnings on principal) may be expended in the course of a fund's designated operations; pension trust funds, which account for transactions, assets, liabilities, and net assets available for plan benefits of the retirement systems; and agency funds, which account for assets held by the primary government and where the primary government acts as an agent for individuals, private organizations, other governments, or other funds. Expendable trust funds earned approximately \$7.6 billion in revenues and had \$7.2 billion in expenditures for the fiscal year

ended June 30, 1997. Pension funds had \$38.3 billion in additions and \$7.5 billion in deductions to the net assets available for plan benefits. Agency funds had assets and liabilities of \$30.2 billion as of June 30, 1997.

Risk Management: The primary government has elected, with a few exceptions, to be self-insured against loss or liability and generally does not maintain reserves. Losses are covered by appropriations in the year in which the payment occurs. Workers' compensation benefits for self-insured agencies are initially paid by the State Compensation Insurance Fund. The liability for future workers' compensation claims against the self-insured agencies is estimated to be approximately \$869 million as of June 30, 1997. The liability of \$106 million is being reported in the General Fund, \$69 million in special revenue funds, \$22 million in proprietary funds, and \$672 million in the General Long-Term Obligations Account Group.

Independent Audit: State statutes require an annual audit of the general purpose financial statements of the State. To meet this requirement, the State Auditor has examined the accompanying financial statements in accordance with government auditing standards issued by the Comptroller General of the United States and generally accepted auditing standards. The auditor's report on the general purpose financial statements and combining and individual fund statements and schedules is included in this report.

The State of California is required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984, the Single Audit Act Amendments of 1996, and the U.S. Office of Management and Budget's Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Generally accepted auditing standards and the standards set forth in the General Accounting Office's Governmental Auditing Standards were used by the auditors in conducting the engagement. Information related to this single audit, including a schedule of federal financial assistance, the independent auditor's report on internal controls and compliance with applicable laws and regulations, and a schedule of findings and questioned costs are included in a separately issued single audit report.

Certificate of Achievement: The Government Finance Officers Association of the United States and Canada (GFOA) awarded the Certificate of Achievement for Excellence in Financial Reporting to the State of California for its Comprehensive Annual Financial Report for the year ended June 30, 1996. This is the first year the State has received this award. To earn this award, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report whose contents conform to program standards. The report must satisfy generally accepted accounting principles and applicable legal requirements.

The Certificate of Achievement is valid for only one year. We believe that this year's report continues to conform to the Certificate of Achievement Program requirements, and we are submitting it to GFOA. We are committed to ensuring that the Comprehensive Annual Financial Report will continue to conform to the Certificate of Achievement Program requirements in the future. The cooperation of state agency accounting departments, the audit by the Bureau of State Audits, and the dedication of the staff of the State Controller's Division of Accounting and Reporting is very much appreciated, without which this award could not have been achieved.

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of
California

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 1996

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Linda K. Savitsky
President

Jeffrey L. Esser
Executive Director

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Pete Wilson
Governor

Gray Davis
Lieutenant Governor

Kathleen Connell
State Controller

Dan Lungren
Attorney General

Matt Fong
State Treasurer

Bill Jones
Secretary of State

Delaine Eastin
Superintendent of Public Instruction

Chuck Quackenbush
Insurance Commissioner

Board of Equalization

Johan Klehs, Member, First District
Dean F. Andal, Member, Second District
Ernest J. Dronenburg Jr., Member, Third District
John Chiang, Acting Member, Fourth District

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Bill Lockyer
President pro Tempore, Senate

Cruz Bustamante
Speaker of the Assembly

Judicial Branch

Ronald M. George
Chief Justice, State Supreme Court

Organization Chart of the State of California

